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The Road Out of Copenhagen

by Suzanne McGee | Dec 17 2009

Private equity firms and other investors are raising capital for alternative energy and cleaner technology.

In Copenhagen, environmental activists are clamoring for world governments to take action to address the extent and impact of climate change. But while government officials and their political leaders fret about the costs of addressing climate change, a cluster of private equity managers and other Wall Street types instead are focusing on the potential profits to be earned from helping companies with solutions to the problems gain access to capital. Picking up the scent of big business opportunities, some of them have shown up in Copenhagen to both participate in and track the discussions.

"Copenhagen is setting the stage for what our fund will be doing over the next five years and longer," says John Cavalier, a former Credit Suisse investment banker and co-founder of Hudson Clean Energy Partners. His partner, Neil Auerbach (a former Goldman Sachs banker) is in Copenhagen this week; Cavalier will head to Davos in the New Year to perform similar intelligence gathering at the annual World Economic Forum. He expects a lot of Wall Streeters with an interest in 'cleantech' investing to show up there, as well, to monitor the buzz. "If you are an adviser to corporations in the energy and utility space, and you want to be a lead player working with your clients, you need to know what is going on," Cavalier argues. "Part of your value will depend on how well you understand how renewables fit into the picture and how you can help your client define and accomplish their objectives in cleantech."

Alternative energy already has emerged as one of the hottest trends in venture capital, with star VC managers like Vinod Khosla (former rainmaker at Kleiner Perkins Caufield & Byers) raising $1.1 billion for two dedicated largely to green investment ideas in September. (One fund will provide seed-stage financing; the other will make $5 million to $15 million cash infusions available to slightly more mature companies. The pace of new green technology venture deals may have slowed this year, but more than half of respondents to a National Venture Capital Association survey (the results of which were released earlier this week) predict a jump in funding next year.

Now the interest in green technology is spreading to the rest of Wall Street, which is slowly starting to recognize that cleantech might end up being just as important and transformative for both the economy and Wall Street as the Internet has been. The best part for Wall Street? These companies—heavily R&D dependent—need a lot of capital, and connecting cash-strapped businesses to interested investors has always been Wall Street's core function. Most importantly, it's also a new potential source of fees.

So far, many of those capital matchmakers have been private equity firms like Hudson Clean Tech, many of which have been founded by former "bulge bracket" investment bankers like Cavalier and Auerbach. "It's a tremendous challenge because the capital requirements still outweigh the available capital." So says Cavalier, only weeks after his firm closed on a $1 billion-plus investment fund of their own, to put to work in companies developing new solar and wind power generating methodologies and bleeding-edge "smart grid" technologies. "Before these companies reach the stage of maturity where they can go public and earn a bank an IPO fee, it takes a lot of capital and effort," adds Cavalier. "We are the people getting those companies through the valley of small-business death to the point where they are late-stage enough to be attractive to acquirers or the public markets."

The small cluster of dedicated "green bankers" on Wall Street tend to see their chosen area of endeavor with an almost Messianic fervor, in much the same way that environmental activists preach the virtues of recycling and local consumption networks.

Jeff McDermott, a former co-head of investment banking at UBS, has set up what (to the best of StreetWise's knowledge) is the only investment banking boutique dedicated to the sector, **Greentech Capital Advisors**, and describes himself as an enabler or a facilitator. "This is about the most difficult space to be an investment banker that I've ever seen," says McDermott. "You have to love it to keep going." The hurdles? Well, aside from the enormous capital needs at a time when capital for risky and unproven business models is thin on the ground, the technology challenges involved, the fact that a successful business model needs to take into account constant changes in both hydrocarbon prices and the cost of electricity (a green technology has to be competitive with coal or gas-fired electricity providers), not to mention myriad government rules, regulations, and incentives.

That makes banking emerging cleantech companies a complex proposition, McDermott admits. But he's not about to retreat from the fray, even though deals may be relatively small in number and hard to come by at the outset. Green technology is "one of these spaces which sounds interesting and sexy but that is still small today." Part of what keeps him going is the billions of dollars of capital being devoted to the sector by both government and private equity investors. Even if the IPO market never takes off in the same way that it did for Internet companies, he figures that at some point the merger market will, as Fortune 500 firms like Siemens, General Electric, Honeywell and United Technologies battle to acquire the most promising of these niche players, earning McDermott some sizeable M&A advisory fees in the process. (For an idea of what's possible, see Daimler's decision to acquire a 10 percent stake in Tesla Motors, maker of cars that run on lithium ion batteries.) But part of the allure, McDermott confesses, goes beyond the economics, and has more to do with what he still sees as Wall Street's raison d'être. "As we meet the companies and the entrepreneurs and the private equity people financing them, well, it gives you hope about our ability to innovate in this country."

Cavalier also waxes rhapsodic about his mission, hearkening back to an early deal he helped do while working at Drexel Burnham. Showing up to talk to his client—an employee-owned industrial firm—he was introduced to the management team with the words: "Here is our banker; he's here to get us the money we need." The managers applauded and cheered. Decades later, in an era where being a banker is more likely to generate jeers and opprobrium and when the business of investment banking has drifted further away from the capital matchmaking services of this kind and into areas like high-frequency trading and structured products, Cavalier hopes that the buzz about green technology can help bankers get back to basics.

Mainstream Wall Street has been relatively slow to jump on this particular bandwagon, however. The green banking business kicked off in Europe—spurred by new regulations that gave renewable power a big boost—and some European-based investment banks caught on. (It's no coincidence that Cavalier and McDermott both emerged from Swiss banks.) It wasn't until a few big IPOs in late 2005 (of SunPower Corp., Suntech Power Holdings Co., followed by more the next year) that other firms got excited. Today, even post-crash, Goldman Sachs, Morgan Stanley, and boutiques like Thomas Weisel's eponymous San Francisco firm are maintaining at least some commitment to banking the sector, galvanized by research showing that solar power could reach "grid parity" in some retail electricity markets in the New Year in some regions and take another four or five years to be competitive across the board.

Even if the policymakers don't manage to cobble together a climate-change pact in Copenhagen by the time the conference wraps up at the end of the week, that's not going to rattle the small but growing coterie of green technology bankers and financiers on Wall Street. Lack of a global pact won't stop individual governments—national, regional, and local—from financing innovation, particularly in the hope of jump-starting both job creation and economic activity. And there's a lot of entrepreneurial zeal around. So what if some of the IPOs—like that of advanced battery manufacturer A123 Systems—seem overpriced to many? "For every deal like that, there will be dozens done in the private market that move the industry forward and generate profits for investors—a win-win," says a banker at one bulge bracket firm, who hopes to devote more of his time to the sector in 2010 and beyond. "Copenhagen may be the be-all and end-all for the governments and the activists, but we'll be providing capital for real innovation and real change anyway. Copenhagen will just give us a framework within which investors will make those capital allocation decisions."